

STATE OF IOWA
DEPARTMENT OF COMMERCE
UTILITIES BOARD

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| IN RE: IOWA-AMERICAN WATER COMPANY | DOCKET NO. RPU-01-4 |
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**ORDER SETTING TEMPORARY RATES AND
APPROVING CORPORATE UNDERTAKING**

(Issued July 16, 2001)

On April 17, 2001, Iowa-American Water Company (Iowa-American) filed with the Utilities Board (Board) a request for a general rate increase in temporary and final water rates. Iowa-American proposed a temporary increase that would produce additional annual revenue of approximately \$2.624 million and a permanent increase that would produce additional annual revenue of approximately \$2.993 million. On May 10, 2001, the Board docketed the proposed tariffs, TF-01-118 and TF-01-119, as Docket No. RPU-01-4.

On May 16, 2001, the Consumer Advocate Division of the Department of Justice (Consumer Advocate) filed an objection to the request for temporary rates. Iowa-American filed a response to the objection on May 30, 2001, and an amendment to the response on June 11, 2001. In addition, Consumer Advocate filed two motions to strike certain portions of affidavits filed by Iowa-American with their responses. The motions to strike were addressed by Board order issued June 28, 2001.

Iowa Code § 476.6(13) (2001) controls the manner in which the Board sets temporary rates. That statute provides, in part:

Upon the request of a public utility, the board shall, when required by this subsection, grant the public utility temporary authority to place in effect any or all of the suspended rates, charges, schedules or regulations by filing with the board a bond or other undertaking approved by the board conditioned upon the refund in a manner to be prescribed by the board of any amounts collected in excess of the amounts which would have been collected under rates, charges, schedules or regulations finally approved by the board. In determining the portion of the new or changed rates, charges, schedules or regulations to be placed in effect prior to a final decision, the board shall apply previously established regulatory principles and shall, at a minimum, permit rates and charges which will allow the utility the opportunity to earn a return on common stock equity equal to that which the board held reasonable and just in the most recent rate case involving the same utility or the same type of utility service, provided that if the most recent final decision of the board in an applicable rate case was rendered more than twelve months prior to the day of filing of the request for temporary rates, the board shall in addition consider financial market data that is filed or that is otherwise available to the board and shall adjust the rate of return on common stock equity that was approved in that decision upward or downward as necessary to reflect current conditions.

In Northwestern Bell v. Iowa State Commerce Commission, 359 N.W.2d 491, 496

(Iowa 1984), the Iowa Supreme Court interpreted this statute and stated, in part:

[I]n the 1983 Code the Assembly telescoped the temporary and permanent rate steps into one procedure, evidently to end the prior problem of a utility's placing its new rates in effect in temporary form under bond and then having little motivation to press forward with the permanent rate aspect. The General Assembly has ended the ability of the utility itself to set the temporary rates in the usual situation; the commission sets them and proceeds to the permanent rates.

If instead the utility could obtain judicial review of temporary rates and obtain its desired rates from the courts, as in this case, its motivation to seek permanent rates would be dulled and fulfillment of the legislative scheme would be hampered. To minimize the possibility of harm to the utilities, the legislature started time running from the original filing as to both temporary and permanent rates...

While permanent rates may ultimately be set higher than the commission's temporary rates, by shortening the time for the commission's final decision to ten months and by streamlining the temporary and permanent rate procedure, the Assembly has demonstrated its desire to minimize utility hardship.

The Board, therefore, is directed to permit Iowa-American to collect rates which, at a minimum, allow the return on common equity equal to that which was held reasonable in the most recent rate case involving the same utility or same type of utility service, provided the Board's decision was rendered within 12 months prior to Iowa-American's request for temporary rates. In addition, the Board is directed to apply established regulatory principles in setting the return on common equity and considering any proposed adjustments. Since the legislature directs the Board to establish a temporary rate level by applying established regulatory principles rather than examining an evidentiary record, it is not appropriate for the Board to make detailed findings of fact on each individual issue.

Consumer Advocate's objection to Iowa-American's request for temporary rates and Iowa-American's replies to the objection narrowed the issues to be considered in setting temporary rates to four income statement issues, two rate base issues, and two cost of capital issues. In addition to the foregoing issues, the Board

will address Iowa-American's request for approval of its corporate undertaking. The issues to be addressed are:

- I. COST OF CAPITAL
 - A. Return on Common Equity
 - B. Capital Structure
- II. RATE BASE
 - A. Capital Projects
 - B. Risk Management Plan and Carbon Removal Study
- III. INCOME STATEMENT
 - A. Loss of Sales
 - B. Bill Analysis
 - C. Labor and Related Expenses
 - D. Accounting and General Office Expense
- IV. CORPORATE UNDERTAKING

I. COST OF CAPITAL

A. RETURN ON COMMON EQUITY

Both parties, consistent with prior Board decisions, recognized the extent of double leverage in the capital structure. Iowa-American proposed to use a 12 percent cost of equity for its parent, American Water Works Company (AWWC). This produces a proposed 11.33 percent cost of equity for Iowa-American using Iowa-American's proposed capital structure. Consumer Advocate proposed an 11.44 percent cost of equity for AWWC, which produces a 10.834 percent cost of equity for Iowa-American using Consumer Advocate's proposed capital structure.

Iowa Code § 476.6(13) (2001) requires that the Board review current financial information if a Board decision on the cost of equity for the same type of utility

service was rendered more than 12 month's prior to the current fling. Because the last litigated water rate case, Iowa-American Water Co., Docket No. RPU-90-10, was decided over 12 months ago, it is necessary for the Board to consider current market data.

The Board has in recent years placed greater reliance on the risk premium method in determining return on equity. Under the Board's risk premium approach, 250 to 450 basis points are generally added to the current A-rated utility bond yield, which is 7.94 percent (Moody's Long-Term Corporate Bond Yields). The risk premium approach produces a cost of equity range of 10.44 percent to 12.44 percent, with the midpoint being the 11.44 percent proposed by Consumer Advocate.

Iowa-American urged the Board to look at both risk premium and discounted cash flow (DCF) analyses, including a modified DCF approach using historical and projected growth. The modified DCF approach produces a range of 11.5 percent to 12.5 percent. The Board has not given much weight to the modified DCF approach in setting temporary rates and will not do so here. Some problems with the approach, which tends to remove market price, should be litigated in a full rate case. The Board will take the higher range indicated by the DCF models into consideration only as a check on the risk premium analysis and, accordingly, the Board finds current market data supports an 11.5 percent cost of equity for AWWC. This becomes, through application of double leverage, an allowed return on equity for Iowa-American of 10.886 percent.

B. CAPITAL STRUCTURE

Iowa-American proposes four pro forma adjustments to its test-year capital structure, three for debt issued between March 30, 2001, and June 1, 2001, and one for equity issued February 1, 2001. These debt and equity issues were primarily used to fund capital projects that are discussed below under rate base issues. While generally the debt and equity adjustments are only allowed for temporary rates to the extent the capital projects are included in rate base, Iowa-American urges these adjustments be included for temporary purposes regardless of the Board's decision on inclusion of some or all of the capital projects in rate base. Because inclusion of Iowa-American's proposed debt and equity adjustments benefits ratepayers by lowering debt costs and decreasing the overall rate of return, the Board will include the adjustments for temporary rate purposes.

II. RATE BASE

A. CAPITAL PROJECTS

There are six disputed adjustments for post-test year capital projects. Iowa-American includes all six post-test year projects as adjustments to increase rate base, while Consumer Advocate excludes the adjustments. Consumer Advocate contends the adjustments do not represent known and measurable changes and have not been useful in providing water service to Iowa-American customers.

The dispute is really over timing. The disputed projects were not in service as of the date of Iowa-American's temporary rate filing, April 17, 2001. However, the

adjustments were proposed in that filing with the most current cost estimates. Iowa-American updated the in-service and current cost information with periodic affidavits, the last filed on July 9, 2001. In denying Consumer Advocate's motions to strike portions of the affidavits, the Board on June 28, 2001, noted that "[t]he affidavits in question do not propose new adjustments or contain additional direct testimony supporting the adjustments, but merely provide more accurate information than the estimates available at the time the temporary rate request was filed."

Iowa-American should earn a return on completed projects that are providing service to customers. Therefore, the Board will include for temporary rate purposes all projects that are shown by the July 9 affidavit to be completed and in-service as of that date. For the Quad Cities district, these projects are the East River Station Clearwell Addition and Transfer Pump station and the Middle Road Ground Storage Tank and Transfer Pump station. For the Clinton district, these projects are Control System Improvements and Replace Small Diameter Mains. The Board will not include the Clinton Well House number 8 Improvements because they are not yet in-service and used and useful to customers.

The Board will also not include any of the Quad Cities Research Parkway and Division Street pipeline. While Iowa-American attempted to divide this project into two phases, with Phase I being complete and Phase II still under construction, there is no evidence that Phase I is used and useful to customers absent the completion of Phase II.

With respect to the amount to be included for each project, the Board will use the most recent actual data. This represents costs incurred through June 30, 2001, and is part of the July 9 affidavit.

B. RISK MANAGEMENT PLAN and CARBON REMOVAL STUDY

Iowa-American seeks to recover costs associated with a plan and study required under federal law and regulations. Both investments were outside and prior to the test year, and Consumer Advocate argues inclusion of the plan and study would constitute retroactive ratemaking.

It is inappropriate to include these costs in temporary rates. Iowa-American will be able in the full rate case to litigate whether these were extraordinary events qualifying for an exception to normal ratemaking standards.

III. INCOME STATEMENT

A. LOSS OF SALES

Iowa-American proposed a \$98,001 adjustment to revenue to reflect the total loss of sales to a major customer, MidAmerican Energy Company (MidAmerican). Subsequently, MidAmerican advised Consumer Advocate it was not completely curtailing service but would reduce its usage by 33 percent in July 2001 with total reductions of up to 87 percent over the rest of 2001 and 2002. Because only a 33 percent loss of sales is known, the Board will make an adjustment to sales in the amount of \$32,340 (one-third of \$98,001). However, the Board will also make matching adjustments to expenses and will reduce the negative Fuel and Power

Expense adjustment from \$5,600 to \$1,867 and the negative Chemical Expense adjustment from \$8,161 to \$2,720.

B. BILL ANALYSIS

Iowa-American performed a bill analysis that showed less revenue was generated than shown on its books, and proposed an adjustment to reflect this revenue reduction. Consumer Advocate argued the adjustments were speculative, because the reasons for the difference in the bill analysis and Iowa-American's books were not identified.

The Board will allow the adjustment for temporary rates because the bill analysis is the most current information available. If the bill analysis is shown to be inaccurate, it can be corrected in final rates.

C. LABOR AND RELATED EXPENSES

Iowa-American proposes adjustments to labor and labor-related expenses that will occur in the 12 months following the filing of the rate case. These adjustments reflect the total number of employees on payroll, the annualized effect of changes in wages and salaries, and health and other benefit increases.

The Board will include for temporary rate purposes salary increases for both union and non-union employees. One union contract became effective June 1, 2001, and the other will be effective by July 16, 2001, the date of this order. Therefore, the two union contracts represent a known and measurable change. Salary increases for non-union workers are also to be in place by the date of this order. If later investigation shows the salary increases for non-union workers were

not given as proposed, an adjustment can be made to final rates. Insurance and post employment benefit increases are also known and in effect, and those increases will be allowed with an adjustment for unfilled positions.

D. ACCOUNTING AND GENERAL OFFICE EXPENSE

Iowa-American proposed an adjustment to accounting and general office expense to reflect that it filled three positions with employees from employment service agencies. While these employees have not been hired on a permanent basis, the Board will allow this adjustment for temporary rates, because the employees have been hired to work full-time and an adjustment has been made to recognize they are not paid for holidays.

IV. CORPORATE UNDERTAKING

Iowa-American filed a corporate undertaking with its temporary rate application. Iowa-American has agreed to refund any temporary rates, with interest, which are collected that exceed final rates ultimately approved by the Board. This corporate undertaking is sufficient to ensure payment of any required refund and will be approved.

ORDERING CLAUSES

IT IS THEREFORE ORDERED:

1. Temporary rates based on this order shall become effective as of the date of this order, pursuant to Iowa Code § 476.6(13) (2001). On or before 20 days from the date of this order, Iowa-American Water Company shall file revised tariff

sheets that produce revenue not to exceed \$22,357,550. Attached to this order, and incorporated by reference, are attachments A through D, reflecting a total water company revenue requirement, rate base, weighted cost of capital, and income statement for temporary rates.

2. Iowa-American Water Company's corporate undertaking is approved.

UTILITIES BOARD

/s/ Allan T. Thoms

/s/ Diane Munns

ATTEST:

/s/ Judi K. Cooper
Acting Executive Secretary

Dated at Des Moines, Iowa, this 16th day of July, 2001.

**Iowa-American Water Company
Revenue Requirement
Docket Number RPU-01-4
Temporary Rates**

| Line No. | Description | Quad Cities District Amount (A) | Clinton District Amount (B) | Total Iowa-American Amount (C) |
|-------------|-------------------------------|---------------------------------------|-----------------------------------|--------------------------------------|
| 1 | Rate Base | \$ 52,046,304 | \$ 8,564,917 | \$ 60,611,221 |
| 2 | Rate of Return | 9.093% | 9.093% | 9.093% |
| 3 | Allowed Return | \$ 4,732,362 | \$ 778,774 | \$ 5,511,136 |
| 4 | Adjusted Test Year Net Income | \$ 3,667,738 | \$ 521,111 | \$ 4,188,849 |
| 5 | Additional Income Required | \$ 1,064,624 | \$ 257,663 | \$ 1,322,287 |
| 6 | Impact on Bad Debt | \$ - | \$ - | \$ - |
| 7 | Income Tax Effect | \$ 383,677 | \$ 202,217 | \$ 585,894 |
| 8 | Revenue Deficiency/(Excess) | \$ 1,448,301 | \$ 459,880 | \$ 1,908,181 |
| 9 | Adjusted Test Year Revenue | \$ 17,169,098 | \$ 3,280,272 | \$ 20,449,370 |
| 10 | Revenue Requirement | \$ 18,617,399 | \$ 3,740,152 | \$ 22,357,551 |

Iowa-American Water Company
Adjusted Rate Base
Docket Number RPU-01-4
Temporary Rates

| Line No. | Description | Quad Cities District Amount (A) | Clinton District Amount (B) | Total Iowa-American Amount (C) |
|-------------|---------------------------------------|---------------------------------------|-----------------------------------|--------------------------------------|
| 1 | Utility Plant in Service | \$ 74,326,081 | \$ 13,657,356 | \$ 87,983,437 |
| 2 | Capital Leases (net of accum. amort.) | \$ - | \$ - | \$ - |
| 3 | Accumulated Depreciation | \$ (16,593,216) | \$ (4,102,527) | \$ (20,695,743) |
| 4 | Net Utility Plant | \$ 57,732,865 | \$ 9,554,829 | \$ 67,287,694 |
| 5 | Accumulated Deferred ITC - pre 1971 | \$ (68,650) | \$ (9,477) | \$ (78,127) |
| 6 | Customer Advances for Construction | \$ (2,271,223) | \$ (333,520) | \$ (2,604,743) |
| 7 | Contributions in Aid of Construction | \$ (1,557,583) | \$ (95,878) | \$ (1,653,461) |
| 8 | Deferred Taxes - Liberalized Depr. | \$ (2,882,058) | \$ (647,427) | \$ (3,529,485) |
| 9 | Customer Deposits | \$ (37,087) | \$ (13,931) | \$ (51,018) |
| 10 | Allowance for Doubtful Accounts | \$ (28,330) | \$ (3,976) | \$ (32,306) |
| 11 | Materials and Supplies | \$ 186,877 | \$ 52,622 | \$ 239,499 |
| 12 | Prepayments | \$ 87,418 | \$ 8,315 | \$ 95,733 |
| 13 | Cash Working Capital | \$ 578,723 | \$ 53,360 | \$ 632,083 |
| 14 | Post-in-Service AFUDC | \$ 305,352 | \$ - | \$ 305,352 |
| 15 | Total Rate Base | \$ 52,046,304 | \$ 8,564,917 | \$ 60,611,221 |

Iowa-American Water Company
Rate of Return
Docket Number RPU-01-4
Temporary Rates

Parent: American Water Works Company

| Line No. | Description | Amount (A) | Ratio (B) | Cost Rate (C) | Weighted Cost (D) |
|----------|------------------|------------------------|-----------------|---------------|-------------------|
| 1 | Long-Term Debt | \$210,586,077 | 11.027% | 6.799% | 0.750% |
| 2 | Preferred Equity | \$48,576,557 | 2.544% | 7.751% | 0.197% |
| 3 | Common Equity | \$1,650,484,387 | 86.429% | 11.50% | 9.939% |
| 4 | Total | <u>\$1,909,647,021</u> | <u>100.000%</u> | | <u>10.886%</u> |

Subsidiary: Iowa-American Water Company

| Line No. | Description | Amount (A) | Ratio (B) | Cost Rate (C) | Weighted Cost (D) |
|----------|------------------|---------------------|-----------------|---------------|-------------------|
| 1 | Long-Term Debt | \$33,605,189 | 55.531% | 7.951% | 4.415% |
| 2 | Preferred Equity | \$3,195,389 | 5.280% | 7.786% | 0.411% |
| 3 | Common Equity | \$23,715,803 | 39.189% | 10.886% | 4.266% |
| 4 | Total | <u>\$60,516,381</u> | <u>100.000%</u> | | <u>9.093%</u> |

Iowa-American Water Company
Adjusted Income Statement
Docket Number RPU-01-4
Temporary Rates

| Line No. | Description | Quad Cities District Amount (A) | Clinton District Amount (B) | Total Iowa-American Amount (C) |
|-------------|---------------------------------|---------------------------------------|-----------------------------------|--------------------------------------|
| 1 | Operating Revenues | \$ 18,617,399 | \$ 3,740,152 | \$ 22,357,551 |
| 2 | Operation and Maint. Expense | \$ 8,100,303 | \$ 1,899,599 | \$ 9,999,902 |
| 3 | Depreciation Expense | \$ 2,118,653 | \$ 435,360 | \$ 2,554,013 |
| 4 | Amort. of Limited Term Plant | \$ 665 | \$ - | \$ 665 |
| 5 | Amort. of Post-in-Service AFUDC | \$ 11,112 | \$ - | \$ 11,112 |
| 6 | Amort. of Reg. Asset - AFUDC | \$ 12,706 | \$ 2,846 | \$ 15,552 |
| | Taxes Other Than Income Taxes: | | | |
| 7 | Real and Personal Property | \$ 1,708,072 | \$ 293,194 | \$ 2,001,266 |
| 8 | Utility Division Fees | \$ 37,873 | \$ 9,468 | \$ 47,341 |
| 9 | Other General Taxes | \$ 4,645 | \$ 1,040 | \$ 5,685 |
| 10 | Federal Unemployment | \$ 3,745 | \$ 1,065 | \$ 4,810 |
| 11 | FICA | \$ 183,839 | \$ 53,141 | \$ 236,980 |
| 12 | State Unemployment | \$ 1,565 | \$ 445 | \$ 2,010 |
| | Income Taxes: | | | |
| 13 | Federal Income - Current | \$ 1,154,466 | \$ 184,886 | \$ 1,339,352 |
| 14 | State Income - Current | \$ 364,261 | \$ 57,723 | \$ 421,984 |
| 15 | Deferred Federal Income | \$ 215,807 | \$ 27,135 | \$ 242,942 |
| 16 | Deferred State Income | \$ - | \$ - | \$ - |
| 17 | Investment Tax Credit | \$ (32,674) | \$ (4,524) | \$ (37,198) |
| 18 | Total Operating Expenses | \$ 13,885,038 | \$ 2,961,378 | \$ 16,846,416 |
| 19 | Net Operating Income | \$ 4,732,361 | \$ 778,774 | \$ 5,511,135 |